

The Federal Reserve System What it Is and What it Is Not

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FEDERAL RESERVE BANK of PHILADELPHIA

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NEARLY seven years have elapsed since the establishment of the Federal Reserve banks and yet there is still a surprising lack of knowledge of what they really are and of what their proper functions are, not only on the part of the public but among bankers as well. Much has been said and written regarding them, which is calculated to create entirely wrong impressions and while it is impossible, in the brief space of time which can properly be allotted to a public address, to enter into an elaborate discussion of the subject, I shall endeavor this afternoon to describe concisely the character and some of the distinctive functions of the Federal Reserve banks and of the Federal Reserve System.

The Federal Reserve Act, which is responsible for the existence of the Federal Reserve Board and the Federal Reserve banks, was approved on December 23, 1913, and has, at various times since, been amended by Congress. The amendments, for the most part, have been the result of suggestions made by the Federal Reserve Board and were designed to render the Act more effective.

The general purposes of the Act are outlined in its caption or short title, which is as follows:

“An Act To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.”

The need for a more efficient banking system in the United States had been felt for many years. Ever since the year 1890 the subject was one which was discussed frequently at bankers' conventions and at gatherings of commercial bodies, but the event which

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gave great impetus to the movement for banking reform along constructive lines was the panic of 1907. The following year Congress created a Monetary Commission, which after a long and thorough study of the banking systems of the world submitted an exhaustive report. During the years 1911 and 1912 a committee of the House of Representatives, commonly known as the "Pujo Committee," investigated banking methods in this country and submitted a report.

With this wealth of information in hand, Congress early in the year 1913 took up the matter of banking reform in earnest and the Federal Reserve Act was put upon the statute books before the close of the year.

This Act is universally admitted to be a great constructive piece of legislation and is applauded both by friends and critics of the Federal Reserve System, by those who understand the Act as well as those who do not. It is because so many have no real conception of the purposes or meaning of the Act that there has been so much criticism of its administration.

The Federal Reserve Act did not establish a central bank. On the contrary, it made possible the establishment of as many as twelve Federal Reserve banks, each wholly independent of the others in operation, as well as in local policies. From a legal standpoint these banks are private corporations, organized under a special act of Congress, namely, the Federal Reserve Act. They are not in the strict sense of the word Government banks, but are only quasi-Governmental institutions, in that they are under the general supervision of the Federal Reserve Board and have on their boards of directors three men, representing the Government, who are appointed by the Federal Reserve Board.

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Each bank has nine directors and the other six are chosen by the member banks, which are the sole stockholders of the Federal Reserve bank. The law does not permit the Federal Reserve banks to compete for business with each other or with the national banks, state banks and trust companies of the country. They are not allowed to receive deposits from the public and can accept deposits only from their member banks, from the United States Government and, solely for the purposes of exchange or collection, from non-member banks or trust companies. They are not allowed to make loans or advances direct to the public, but can lend only to the United States, to their member banks and, subject to certain conditions, for periods not exceeding six months, in anticipation of the collection of taxes or the receipt of assured revenues, to states, counties, municipalities and other political subdivisions in the United States.

In lending to their member banks Federal Reserve banks are not permitted by law to use the same discretion that is allowed national banks, state banks and trust companies, but they must observe the limitations prescribed by law as to the character and maturity of the notes offered them by member banks for discount. Except as to notes, drafts and bills, drawn or issued for agricultural purposes or based on live stock, which a Federal Reserve bank may discount for a member bank if the maturity does not exceed six months, a Federal Reserve bank can not discount any paper which has longer than three months to run, exclusive of days of grace.

The law puts a limitation also upon the character of a note which a Federal Reserve bank may discount for a member bank. A Federal Reserve bank may make advances to its member banks on their promissory notes, for a period not exceeding fifteen days,

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provided, such promissory notes are secured by the deposit or pledge of bonds or notes of the United States, or by notes, drafts and bills of exchange or bankers' acceptances which are themselves eligible for rediscount or purchase by a Federal Reserve bank. To be technically eligible for rediscount a note must be endorsed by a member bank, its maturity must be within the time limit prescribed by law and it must have been issued or drawn for agricultural, industrial or commercial purposes, and it must also be shown that the proceeds of the note have been used or are to be used for such purposes.

Federal Reserve banks are forbidden by law from discounting notes, drafts or bills, covering merely investments, or issued or drawn for the purpose of carrying or trading in stocks, bonds or other investment securities, except bonds and notes of the Government of the United States.

The Federal Reserve Act, as amended, has changed both the amount and character of the reserves which all national banks and state member banks must carry against their deposit liabilities. For a long period of years, it has been the practice of American banks to carry as a reserve in cash and on deposit with other banks, a certain proportion of their deposits. Before the passage of the Federal Reserve Act, the national banks in the three central reserve cities were required to keep in their own vaults as reserve in gold or lawful money an amount equal to 25 per cent of their net deposits, and in other cities and towns they were required to keep a part of their required reserves in cash in their own vaults and a part on deposit with other banks. The laws regarding the reserves of state banks varied in the different states. Under the Federal Reserve Act the percentage of reserve required has been substantially reduced,

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and as amended, no national bank and no state member bank is required to keep any definite amount of cash in its own vaults and whatever amount of cash is kept on hand by the member banks, as deemed necessary by the judgment and experience of their officers, does not count as part of the banks' lawful reserve.

The entire legal reserves of all member banks must be kept on deposit with the Federal Reserve banks. As a consequence, the cash resources of the Federal Reserve banks are necessarily very large and their holdings of gold, in particular, constitute a very large proportion of all the gold in the country. The gold held by the Federal Reserve banks is equal substantially to all the gold that might have been held by all the banks throughout the country if there had been no Federal Reserve banks established.

As the Federal Reserve banks are made the sole custodians of the legal reserves of all member banks, the object of Congress in throwing safeguards and limitations around their loan transactions is evident. It is necessary that Federal Reserve banks should keep themselves in a "liquid" position, that is, their bills discounted must be of short maturity and should be readily collectible. The strength of the entire banking system of the United States is directly related to the strength of the Federal Reserve banks. If a Federal Reserve bank should find itself in a weak, over-extended or unsafe position, all its member banks would be directly affected.

While Congress has placed upon the Federal Reserve Board the responsibility of defining eligible paper, within the meaning of the Federal Reserve Act, it has entrusted the management of the Federal Reserve banks, under the general supervision of the Federal Reserve Board, to their own directors. Each

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Federal Reserve bank has power to appoint, by its board of directors, such officers and employees as are not otherwise provided for in the Federal Reserve Act and to define their duties, to prescribe by-laws, not inconsistent with the law, regulating the manner in which its general business may be conducted, and to exercise, by its board of directors, or duly authorized officers or agents, all powers specifically granted by law and such incidental powers as may be necessary to carry on the business of banking within the limitations prescribed by law.

Each Federal Reserve bank is conducted under the supervision and control of its board of directors, who are charged by law to perform the duties usually appertaining to the office of directors of banking associations and to administer the affairs of the bank fairly and impartially and without discrimination in favor of or against any member bank or banks and, subject to the provisions of law and the orders of the Federal Reserve Board, to extend to each member bank such discounts, advancements and accommodations as may be safely and reasonably made with due regard for the claims and demands of other member banks.

The Federal Reserve Board does not appear to be authorized by law to pass upon the paper which is offered for discount to Federal Reserve banks. This is a function which must be exercised by the directors of the Federal Reserve bank or by their duly authorized officers or agents. While the law does not prescribe any fixed limit as to the amount of loans that a Federal Reserve bank may make to a member bank, it does require that due regard must be given to the claims and demands of other member banks, that is, to their possible needs for credit accommodation. It also provides that a Federal Reserve bank must extend to each member bank such discounts and accom-

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modations as may be "safely and reasonably made." This means that the directors of a Federal Reserve bank and the officers appointed by them must exercise their best judgment in granting discount accommodations. They must assure themselves that the discounts are such as can be safely made, and reasonably made, with due regard to the possible requirements of other member banks which may ask for accommodations later on.

This discretion is not vested in the Federal Reserve Board and the reason for this is probably two-fold. First: the Federal Reserve System is not a central bank. It is a regional system comprising twelve banks. Congress did not intend that there should be a centralized control of credits. Second: in a country embracing so vast an area as the United States, it would be a very difficult task, if not an impossibility, for a central Board to pass intelligently upon the security of the paper offered for discount, which must necessarily come from all sections of the country.

I have already called your attention to the fact that Federal Reserve banks are not permitted by law to make loans direct to individuals, firms or corporations, and that they can only rediscount paper which bears the endorsement of a member bank. It is evident, therefore, that in order for a Federal Reserve bank to render financial assistance to those engaged in commerce or industry, in agriculture or in the raising of live stock, the loans must first be negotiated with member banks. There are many loans, however, which member banks may legally and properly make which can not be rediscounted with Federal Reserve banks for the reason that the law does not admit of the classification of such paper as eligible. A Federal Reserve bank, therefore, can not discount any paper, however good it may be, which is not technically

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eligible under the terms of the Federal Reserve Act, and, on the other hand, it is entirely within its rights in declining to discount notes which, even though technically eligible, are not satisfactory from a credit standpoint.

While the Federal Reserve Act was intended to strengthen the banking system of the United States and to provide ready means of rediscounting certain classes of paper, it is also the evident intention of the Act to disturb as little as possible the business of the member and non-member banks, or their dealings with their customers. There is nothing in the Federal Reserve Act which gives either the Federal Reserve Board or a Federal Reserve bank any control over the loan policy of any member bank. A Reserve bank cannot compel a member bank to make a loan which it does not desire to make nor restrain it from making a loan which it wishes to make even though it is forbidden by law.

I have already explained that a Federal Reserve bank cannot lend directly to the customers of a member bank, nor does it, in fact, take the initiative in making loans to a member bank for the purpose of enabling the member bank to distribute the funds so advanced to its customers. The Federal Reserve bank lends to the member bank against transactions already made, for the purpose of enabling the member bank to restore its reserve to the legal requirement, after the reserve has been impaired or is about to be impaired because of increased loans and deposits.

I know that there is a very general popular misconception regarding this and I think that some of the member banks are responsible for this misunderstanding, although, I am sure, they have not been actuated by malicious motives. I have been in the banking business myself and I think that I know

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something of banking psychology. Banks, as a rule, do not like to admit to customers that they are short of loanable funds nor do they like to arouse enmity in declining to make loans or in asking for a reduction of a loan already made.

I know that there are some bank officers who are able frankly to decline an application for a loan in a way which leaves no sting, but which on the contrary gives the applicant the impression that the rejection of his application is a favor to him. But not all bank officers have such tact. Some are frank enough but their bluntness hurts the feelings of the would-be borrower. It is not unusual, therefore, for bank officers in declining loans to look for a buffer, or some one to whom they can "pass the buck." In the old days, the board of directors was made useful in this capacity. By way of illustration I am going to tell you a story which was told me by a native of North Carolina and who, by the way, was one of the best citizens that the Old North State ever gave to Alabama, the Honorable Joseph F. Johnston, who was Governor of Alabama for two terms and who died some years ago while he was a Senator of the United States.

He was formerly president of a bank in Birmingham and he used to enjoy telling this joke on himself. It seems that one day a man, whom I shall call Jones, who had no credit responsibility and no visible means of support, but who was an all-round good fellow and had some little political influence in local elections, came into the bank and wanted to borrow \$300. Governor Johnston asked him what collateral he had.

"Well," said Jones, "I haven't got any. If I had any collateral I would sell it and I would not want to borrow any money."

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“Well,” Governor Johnston said, “Who is going to endorse your paper for you?”

Jones replied, “I do not know anybody who will endorse my paper. I want to borrow it on my own name.”

Governor Johnston was anxious not to offend the fellow, so he said, “I will tell you what I will do. I cannot promise offhand to let you have the money, but I will see our directors about it and if they approve the loan I will be very glad to make it for you.” There were only seven directors and they all had offices in the business section of the town, so Jones got busy and went around and saw each one of the directors of the bank and he ascertained also when the next directors’ meeting would be held. The day following the directors’ meeting Jones came in with his note all filled out and said:

“All right, here is my note. Let me have the money.”

Governor Johnston said, “I am very sorry, my friend, I cannot make the loan; the directors turned it down.”

“What,” Jones exclaimed, “Did they turn that loan down?”

“Yes, they did.”

“Well,” said Jones, “That is very queer. I saw Mr. A and Mr. B; I saw every one of the directors, and they all said I could have the money. All of them were in favor of it.”

“Well,” Governor Johnston said, “I cannot help what they told you. I brought the matter up at the directors’ meeting and they all voted to turn it down.”

“Well,” Jones replied, “All I have to say, Governor Johnston, is that personally and separately your directors are a very clever set of men, but collectively they are the biggest liars in Birmingham.”

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In these days, however, bank officers find in the Federal Reserve Board or the Federal Reserve bank a much more satisfactory buffer than a local board of directors. I know of many cases where banks have found it very convenient to pass the buck to the Federal Reserve bank or the Federal Reserve Board, and have stated to a borrower or would-be borrower that they would like to grant the extension asked for or make the loan desired, but the Federal Reserve would not permit it. Such a procedure has a tendency to relieve the situation as far as the local bank is concerned but it is certainly unfair to the Federal Reserve System. This evasion of responsibility has subjected the Federal Reserve banks to a great amount of unjust criticism and has given the public a wrong impression of the authority and attitude of the Federal Reserve banks and the Federal Reserve Board. It has aroused indignation which is entirely natural in the circumstances and has caused much correspondence with the Federal Reserve Board direct and with Congressmen and United States Senators, whose ire has been aroused because of these alleged arbitrary methods.

It is entirely true that a Federal Reserve bank, mindful of its responsibility under the law and acting in accordance with the dictates of ordinary banking prudence, may have had occasion to call the attention of some of its larger borrowing banks to their large discount lines, which have run in some cases over a period of years, without being reduced, and have called the attention of the borrowing banks to the necessity of working themselves into a stronger position. But in no case within the knowledge of the Federal Reserve Board has any Federal Reserve bank undertaken to say to a member bank what particular loans it should call or ask to have reduced.

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I will give you a concrete example. In another state, not in this Federal Reserve district, there is a national bank which has for a long time been a large and continuous borrower at the Federal Reserve banks, the amount of its rediscounts being several times greater than its capital stock and its fair proportion of the loanable funds of the Reserve bank. It seems that this bank has made frequent promises to reduce its discount line to a more reasonable sum, but as it collected notes it would constantly send in others for rediscount.

I hold in my hand a notice that this bank appears to have been sending to some of its borrowing customers, which reads as follows:

“Your note for \$———falls due ————.

“Our *Federal Reserve Bank* owns this note, having rediscounted it for us. As it has been renewed several times, they are *insisting on a payment* of \$—— or more. It is *absolutely necessary* to arrange this note on the day of its maturity. Yours truly. Cashier.”

The cashier of this bank recently wrote the Federal Reserve bank as follows:

“We wish to assure you that we appreciate your help and could not have gotten along without it. We are more anxious to reduce our line than you are to have us do it. To show you how desirous we are to get our line down I am enclosing a notice which we have lately gotten out and which is producing excellent results. Now be patient with us just a little longer and we will show you that we can reduce our line to a respectable size. We thank you just the same.”

To this the Federal Reserve bank replied promptly:

“We are pleased to note from your letter of September 9th that you anticipate being able before very

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long to materially reduce your large borrowings from us in a gradual manner. We do not, however, feel that you are justified in sending a notice to borrowing customers as per the form which you enclosed, as it makes statements that are entirely uncalled for. The papers that you have had under rediscount with us and which we accepted as being eligible in order to extend to you needed aid, represent loans that the officers of your bank have passed upon from the standpoint of the credit worth involved, and, no doubt, with the consideration as to their collectibility when due, and, therefore, when the time comes for making collection, it would seem that, being conversant with local conditions, ways and means for making collection could be devised by the same officers without laying the burden upon the Federal Reserve bank. This bank has never set forth to your institution what loans it should or should not make, nor has it stated that any particular note or notes that it has held under rediscount from your bank should be collected. We have extended accommodation to you over a long period which, in our opinion, was the time when credit was needed in order to aid your customers in their commercial, industrial and agricultural operations, but when the harvesting and marketing period arrived and there seemed to be little or no reduction in your borrowing, we deemed it advisable to bring to your attention the desirability of efforts being made to get out from your seriously extended position. The desired amount of curtailment in the indebtedness of your individual customers is a matter that should be worked out by your directors and officers, they bearing in mind the extended position of your institution and its safety. We would ask therefore that you discontinue at once using the form of notice referred to and that you also recall the

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notices of a similar tenor that have already been sent to your customers.”

To this the member bank replied:

“Your letter of the 10th instant was received this morning. Fortunately we had not issued any of the notices in question and have destroyed the entire supply. Am sorry the incident occurred.”

No doubt the Federal Reserve Board will receive many complaints growing out of this incident.

There is perhaps even greater confusion in the public mind regarding the issue of Federal Reserve notes than there is regarding the rediscounting functions of the Federal Reserve banks. The impression seems to prevail very generally that the Federal Reserve Board has power to expand or contract the currency of the country at will and some believe that it has exercised this power in a reckless and arbitrary manner. While the law prescribes that the Federal Reserve Board shall have the right, acting through the Federal Reserve Agent, to grant in whole or in part or to reject entirely the application of any Federal Reserve bank for Federal Reserve notes, it has never exercised this right. On the contrary, it has always approved promptly every application which has been made for the issue of Federal Reserve notes. One of the purposes of the Federal Reserve Act, as stated in its caption, is to furnish an elastic currency, but there are many whose idea of elasticity is continuous stretching.

Currency to be really elastic must be susceptible of expansion or the reverse, as the needs of industry and commerce may require. Many believe that there was a preordained contraction of the currency during the year 1920, determined upon in order to reduce prices. The facts, which can be readily ascertained from the figures which were published every week

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during the year 1920, show that this impression is absolutely unwarranted. The Federal Reserve Board said in its Annual Report for 1919:

“The expansion of credit set in motion by the war must be checked. Credit must be brought under effective control and its flow be once more regulated and governed with careful regard to the economic welfare of the country and the needs of its producing industries. Deflation, however, merely for the sake of deflation and a speedy return to “normal”—deflation merely for the sake of restoring security values and commodity prices to their prewar levels without regard to other consequences, would be an insensate proceeding in the existing pressure of national and world affairs.”

It said also in that report:

“It must never be forgotten that productive industry is profoundly affected by credit conditions. Modern business is done on credit. One of its life-giving principles is credit. The mood and temper of the business community are deeply affected by the state of credit and may easily be disturbed by ill-considered or precipitate action. . . . Too rapid or too drastic deflation would defeat the very purpose of a well-regulated credit system by the needless unsettlement of mind it would produce and the disastrous reaction that such unsettlement would have upon productive industry. Radical and drastic deflation is not, therefore, in contemplation, nor is a policy of further expansion. Either course would in the end lead only to disaster and must not be permitted to develop. Our economic and financial position is essentially strong. There need be no occasion for apprehension as to our ability to effect the transition from war-time to peace-time conditions if reasonable safeguards against the abuse of credit

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are respected. There is, however, no need for precipitate action or extreme measures. Extremes must be avoided, the process of adjusting the volume of credit to a normal basis should be effected in an orderly manner, and its rapidity must be governed by conditions and circumstances as they develop. Much will depend upon the coöperation of the business and general community. Indeed without such cooperation progress can be neither rapid nor substantial. Much will depend also upon the rapidity with which the unabsorbed portion of the outstanding issues of war securities passes into the hands of permanent holders. As the national debt is thus absorbed and as it is reduced through the operation of the sinking fund, the loan accounts of the banks should be reduced correspondingly until the proper balance between the volume of credit and the volume of concrete things, which credit helps to produce and which are the normal basis of credit, is restored. This equilibrium, it cannot be too frequently or too emphatically stated, can be restored only by speeding up the processes of production, by the orderly distribution of goods, by the avoidance of wasteful consumption, and by the increased accumulation of savings. These are the fundamental economic processes upon which the proper functioning of the Federal Reserve banks must depend. The Federal Reserve System can do much to assist these processes but it can not of itself and alone compel them. Efficacious action along these lines involves the intelligent and earnest coöperation of the business and general community. While the Federal Reserve Board will always be mindful of the interdependence of credit and industry and of the influence exerted on prices by the general volume of credit, the Board nevertheless can not assume to be an arbiter of industry or prices. Its

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primary duty, as the guardian of the Nation's ultimate banking reserve, is to see that the banks under its supervision function effectively and properly as reserve banks."

It is not the function of the Federal Reserve System or of any banking system to attempt to fix or control prices. Banks are concerned with prices only in so far as the security of their loans may be involved, and they are interested more in the stability of prices and their margin of collateral than in the price level itself. Banks do not create general conditions, but they must adjust themselves to changing conditions, which, in the recent eventful months, have been brought about by the irresistible force of popular sentiment throughout the world.

There was not only no contraction in Federal Reserve note currency during the year 1920, but on the other hand the total volume of Federal Reserve notes in circulation shows an almost continuous upward trend during that year, rising from \$2,844,000,000 on January 23rd, to \$3,404,000,000 on December 23rd, a record high mark. Since that time the volume of Federal Reserve notes in circulation has been greatly reduced, until on September 14, 1921 it stood at \$2,491,651,000. I wish to reiterate that neither the increase nor the decrease in the volume of Federal Reserve notes outstanding is the result of any preordained policy or premeditated design, for the volume of Federal Reserve notes in circulation depends entirely upon the activity of business, and upon the kind of activity which calls for currency rather than book credits. As I have already stated, one of the purposes of the Federal Reserve Act was to provide an elastic currency. United States notes, or legal tenders, are required by law to remain at a fixed amount, \$346,681,016. National bank notes are se-

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cured by Government bonds and these notes do not have the qualities of elastic currency. Their volume has never depended upon the actual need for currency so much as upon the price of Government bonds which have the circulation privilege and there has been only a moderate change in the volume of national bank notes outstanding for several years past. Federal Reserve notes, on the contrary, are distinctly elastic. They may be issued to Federal Reserve banks against collateral in an amount equal to the sum of the Federal Reserve notes applied for, which collateral security is required to be notes and bills discounted or acquired by the banks, or gold or gold certificates. The law provides further that each Federal Reserve bank shall maintain a reserve of 40 per cent in gold against its Federal Reserve notes in actual circulation. As an evidence of the elastic quality of Federal Reserve notes may be cited the fact that on April 1, 1917 the total outstanding was \$357,239,000; on August 1, 1919 the total amount outstanding had increased to \$2,506,820,000 and, as has just been stated, the maximum amount ever in circulation, \$3,404,000,000, was reached on December 23, 1920, although prices had already begun to decline several months before that date.

Since the first of the present year the loans of the Federal Reserve banks to their member banks decreased up to September 1st about \$1,200,000,000 and as the notes discounted with Federal Reserve banks have been paid off Federal Reserve note currency has come back to the banks and in the absence of a demand for it, has not been reissued. Upon payment of commercial paper which has been deposited to secure Federal Reserve notes, there necessarily results either an immediate return of an equivalent amount of notes to the bank or an automatic in-

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crease in the percentage of gold reserve available for their redemption. Federal Reserve notes are not legal tender, nor do they count as reserve money for member banks. They are issued only as a need for them develops and as they become redundant in any locality they are returned for credit or for redemption to the Federal Reserve banks or to the Treasury at Washington. Thus, there cannot be at any time more Federal Reserve notes in circulation than the needs of the country at the prevailing level of prices and wages require, and as the demand abates the volume of notes outstanding will be correspondingly reduced through redemption. The increased volume of Federal Reserve notes in circulation from 1917 to the end of the year 1920 was, in so far as it was not the result of direct exchanges for gold and gold certificates, the effect of advancing wages and prices and not their cause, just as the reduction which has taken place during the present year is the result of lower prices and smaller volume of business, rather than their cause. Under the Federal Reserve System, as business expands, as labor is more fully employed and as production increases and distribution becomes more active, there follows a demand for greater discount accommodations and a need for more currency, and the increased volume of discounts furnishes a means of providing the increased volume of currency required.

As long as Federal Reserve notes are redeemable in gold and the required reserves are maintained, it is difficult to see how there can be any inflation of the currency growing out of the issue of Federal Reserve notes. The notes can only be issued in exchange for gold or gold certificates or against the security of commercial paper which has first been discounted with some member bank. The currency inflation

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which now exists in other countries, and which existed in this country during and after the Civil War, is due, first: to the suspension of gold payments, second: to an unbalanced budget, that is, insufficient revenues to enable the Government to pay its current expenses, and third: to the issue of irredeemable paper currency either by the Government direct or by a central bank against Government securities, and the forcing of such notes into circulation in payment of Government obligations and private indebtedness.

The most conspicuous examples today of countries having inflated currencies are Germany and Russia.

Here in the South, we are all rejoicing over the recent advance in the price of cotton. This advance is not due to any increase in the loans of the Federal Reserve banks or to any expansion of the currency. As a matter of fact, the amount of Federal Reserve notes in circulation today is about \$500,000,000 less than when cotton reached its lowest point last spring. The advance in the price of cotton is due to economic causes, to the operation of the inevitable law of supply and demand. After the last report of the Department of Agriculture, the world awakened to the fact that the present crop is abnormally small and that probably less than seven million bales will be produced. In ordinary circumstances a partial crop of this kind would have been calamity to the South, but owing to the large amount of cotton left in the hands of producers from last season, it will be a benefit because a more normal equilibrium of the market will be restored and therefore the debt-paying and purchasing power of the South this fall will be far greater than had been anticipated.

I wish to emphasize, however, the fact that this happy result is due, not to credit or currency expan-

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sion but rather to the deflation of the anticipated supply of cotton.

Touching again upon the credit policies of the Federal Reserve banks during the year 1920 and at the present time, I wish to remind you that a change in the discount rate is not necessarily a change in policy. Central banks in foreign countries have been accustomed for generations to advance or reduce their rates of discount in accordance with changing conditions in their money markets and their action is accepted without popular protest.

The discount rates of the Federal Reserve banks during the year 1919 were below the market rates, as was the case during the greater part of the period when the country was at war. The war did not end, however, in a financial sense, with the signing of the armistice and the exigencies of the Treasury seemed to require a continuance for some months of the Federal Reserve discount rates which prevailed during the war.

In January, 1920, however, Federal Reserve rates were advanced generally to 6 per cent, which, by the way, is the highest rate that has ever been charged by the Federal Reserve Bank of Richmond. This advance in rates took place at a time when there had been ample opportunity to market the crops of 1919 and before preparations were made for planting the crops of 1920.

The effect of this increase in discount rates at the Federal Reserve banks was to reduce the degree of expansion of their loans, although the volume of Federal Reserve discounts still continued to show a tendency to increase. At the end of January, 1920, the total earning assets of the Federal Reserve banks, which include rediscounts for member banks, amounted to \$3,039,191,000, as compared with

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\$3,396,043,000 at the end of October, 1920. During this period the drastic decline in prices had already set in, although there had been a very substantial increase both in the volume of rediscounts of the Federal Reserve banks and in the amount of their Federal Reserve notes in circulation.

There is no occasion for me to say that the year 1920 was a critical and disastrous one. There are thousands of people in this state who can bear witness to this out of their own knowledge and experience, but the ordeal through which you have passed is the same ordeal which was undergone at the same time by people in all other States in this country and by millions of people throughout the civilized world. The reaction, when it came, was overdue and was brought about by world-wide economic causes, which were entirely beyond the control of any group of banks, of any Board or of any Government.

The President of the United States in an address to the Senate last July said: "Our land has its share of the financial chaos and the industrial depression of the world. We little heeded the growth of indebtedness or the limits of expenditure during the war because we could not stop to count the cost. Our one thought then was the winning of the war and the survival of the Nation. We borrowed and loaned—individuals to the Nation and the Government to other Governments, and to those who served the Nation, with little thought of settlement. It was relatively easy then, because national life was at stake. In the sober aftermath we face the order of reason, rather than act amid the passions of war, and our own land and the world are facing problems never solved before. There can be no solution unless we face the grim truths and seek to solve them in resolute devotion to duty. . . . It is unthinkable to

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expect a business revival and the resumption of the normal ways of peace while maintaining the excessive taxes of war. . . . The slump which is now upon us is an inevitable part of war's aftermath. It has followed in the wake of war since the world began. There was the unavoidable readjustment, the inevitable charge-off, the unfailing attendance of losses in the wake of high prices, the inexorable deflation which inflation had preceded. It has been wholly proper to seek to apply Government relief to minimize the hardships and the Government has aided wherever possible, and is aiding now, but all the special acts ever dreamed of, all the particular favors ever conceived will not avoid all the distresses nor ward off all the losses. The proper mental state of our people will commit us resolutely and confidently to our tasks, and definite assurances as to taxation and expenditure will contribute to that helpful mental order. The only sure way to normalcy is over the paths nature has marked throughout all human experience."

When things go wrong, especially in matters pertaining to economics and finance, there are always many people who are unwilling to consider the abstract causes, but prefer to seek the concrete and the personal. They demand a personal scapegoat. Some people have made it their business to charge, and may have deluded others into believing, that the Federal Reserve banks and the Federal Reserve Board, particularly, have caused a great economic crisis, which was foreseen by those responsible for the management of the Federal Reserve System, but which was most certainly not brought about by them. On the other hand they did everything within the bounds of reason and the limitations of law to relieve the crisis and to avert a financial panic, which everyone will now admit has been averted, whether the

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Federal Reserve System be commended or criticized for the part it played in the drama, which but for its existence would have developed into the greatest financial tragedy of modern times.

I wish now to introduce the testimony of one who is at present the star witness of those who seek to hold the administration of the Federal Reserve System responsible for the financial and economic ills which afflict the country.

I hold in my hand the report of the Comptroller of the Currency for the year 1920. This report is dated December 6, 1920 but was actually sent to Congress in page proof form on February 7, 1921.

There is nothing in this report which reflects in any way upon the administration of the Federal Reserve System nor is there anywhere a suggestion that the precipitate decline in prices and the general depression which set in during the last half of the year was due in any respect to the policies or operating methods of the Federal Reserve System. On the contrary several pages are devoted to a discussion of the world-wide economic causes which brought about the drastic reaction, and I shall now read to you several passages in the report which refer to the Federal Reserve System.

From page 6: "The story of Japan's industrial and financial experience is largely similar to the experience of South American and European countries—some of them our allies, and others neutral. Some of these countries are now going through a business cataclysm similar to that through which Japan has so recently passed. In our own country we have been thus far fortunate enough—thanks largely to the splendid efficiency and stabilizing influence of the Federal Reserve System—to avoid the financial crises and complete disorganization which have made

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havoc elsewhere. We have passed with comparative safety through exceedingly troubled and nerve-racking times; but difficult and dangerous problems remain to be solved, the solution of which will demand clear heads and steady nerves."

From page 11: "The deflation which at that time (1919) was obviously inevitable has come, and the country is now in many respects on a sounder basis, economically, than it has been for years."

From page 52: "Largely through the aid and excellent functioning of the Federal Reserve System, the business and banking interests of the country have passed successfully through the perils of inflation and the strain and losses of deflation without panic and without the demoralization which has been produced in the past at various times from far less serious and racking causes. Those banking and other interests which at the outset so vigorously opposed the Federal Reserve System are now among its warmest advocates."

From page 291: "The past seven years have been, in numbers of persons and extent of interests involved, the most momentous and critical in the history of this Republic. We have had to face and solve gigantic and unprecedented problems, and the banking and financial machinery of the country has been subjected to a test and strain unparalleled. It has been the duty of our country very largely to finance the world, and in carrying out the program which fate imposed upon us we have overcome successfully difficulties that at times seemed almost insurmountable and we have met every righteous demand made upon us. Our Federal Reserve financial and banking system, inaugurated in 1914, has been of inestimable value; and without its aid, tasks which we have so successfully accomplished would have been impossible."

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I feel that I should not close without saying something about present conditions and future prospects. The banking situation has greatly improved and with respect to it the gloomy forebodings of last winter are no longer justified and can be dismissed. The process of readjustment has not yet been completed but evidences are multiplying that the corner has been turned and that we have passed the most acute stage of the readjustment period.

Much will depend upon developments in the agricultural sections of the country and upon the manner in which the crops are marketed. While all sections have suffered, the burden of debt and the lack of buying power is felt more keenly in the farming districts and no sustained forward movement in commerce and industry can be expected unless an improvement is seen and felt in these districts, in which normally so large a part of the country's purchasing power lies. With proper cooperation on the part of merchants and bankers, those engaged in agriculture have now opportunities and prospects which were not anticipated a few months ago and it is of vital importance that this cooperation be given.

It should be remembered, also, that in order to maintain our rate of production we must push our foreign trade. We produce more cotton, more foodstuffs, more copper and more manufactured articles of great variety than we need for our own use. In the changed conditions resulting from the war, America occupies a new relationship to the world. We are not longer a debtor nation, as we were in 1914, but today we are the world's great creditor nation. We have an enormous stock of gold, much of which has come to us during recent months from all quarters of the globe in payment of commodities purchased from us.

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We cannot forever maintain our foreign trade, however, on the basis of the gold stock of other nations. Some means must be devised for extending long time credits abroad or of interesting American investors in foreign properties and securities, in order that the exchange which now runs so heavily against other nations may be corrected.

We must continue to buy from foreign countries those things which they can produce better or more cheaply than we can and exchange commodities with them. If we determine to do business with and for ourselves alone, it seems inevitable that we must reduce our production to meet merely American requirements.

One word more about the Federal Reserve System. Do not expect it to do the impossible. It is not a panacea for all economic and financial ills and it cannot, however skillful its administration may be, prevent periods of depression in the future, although it can do much to modify them. Other nations, such as Great Britain and France, with their great central banking institutions, have always had their years of prosperity and their periods of depression, although they have been free from the money panics which we formerly had in this country as a result of our inadequate banking system.

All history shows that periods of prosperity and depression come in cycles, the rotation being about as follows: (1) Prosperity, (2) Liquidation, (3) Stagnation, and (4) Revival. At the present time the process of liquidation is well advanced and the end of stagnation and the beginning of the period of revival seem now to depend upon certain things which are susceptible of accomplishment in the near future, among which may be enumerated the financial rehabilitation of our great transportation systems and

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the determination of the policy of the Government with respect to revenues and the tariff.

When the period of revival does definitely set in, to be followed by a new era of prosperity, let us remember that the greater the wave of prosperity and the more unrestrained the expansion and the speculation accompanying it, the sharper will be the depression that will follow. If, however, the lessons of the past two years are remembered, the next period of prosperity will be of longer duration than any we have had before and the subsequent reaction will be far less severe.